The gold market looks to enter 2011 with a very long list of bullish themes. Not surprisingly, historic price levels are being accompanied by truly historic conditions. However, after a decade-long run-up in prices, we think that the market is poised to make a rather fantastic top. With nearby gold prices almost six times as high as they were when they made low in 1999, clearly the market has made a dramatic return from being on the ash heap of the investment world to what might be called the world’s most favored asset. When it put in its low, the market made what we consider a classic, “textbook” bottom. In looking ahead for signs of an eventual top, we suggest traders consider the inverse of the 1999 “textbook” as a model.

However, while we see the gold top drawing nearer, being able to predict the actual price high could prove difficult, as the gold market is currently drawing capital from almost every corner of the earth. For a couple of years now we have suggested that the final rally in gold would probably not come as a result of flight to quality issues, but instead because the flight to quality issues had been appeased and inflation was on the march. We think gold will forge a major historical top in 2011, but that top could be $1,400, $1,500 or even higher. When the time comes to determine whether the gold market has topped, we will look to the key factors that caused the 1999 bottom. When those indicators reach extreme levels, we will consider gold to be into its end-game.

By the late 1990’s low gold prices were under heavy pressure, with prices falling to the cost of production at some mines.
As gold approached the $250 per ounce level, high-cost mines were trimming production, and capital for new ventures was dwindling. The downtrend in gold prices was so entrenched that banks that owned gold were loaning it out in hopes of being able to buy it back at cheaper levels. The futures trade was so convinced that gold was headed lower that the speculator net short position repeatedly made new records. Gold producers were even selling their future production.

Not surprisingly, this pervasively bearish environment prompted central banks to make the now infamous suggestion that gold was no longer an investment class instrument.” To add insult to injury, the Dollar was in the midst of a sharp appreciation that led many to conclude that the Greenback, and not gold, was the ultimate safe-haven instrument. Lastly, the sharp run up in equities that started in 1994 and was burning hot by 1999 created the impression that gold investors were missing out on the huge rates of return that were being offered by mutual funds and other equity vehicles.

In short, by 1999 almost everyone that would or could participate in the short side of gold was doing so, including central banks, producers, banks and futures and options traders. Furthermore, the investment environment was such that gold was simply being viewed as part of a washed up asset class known as “commodities.” The final piece of the puzzle was the economy, which was getting ready to burst the tech bubble.

In 1998, the US Federal Reserve Bank lowered interest rates three times, but in 1999 it reversed and raised interest rates three times. Going into the gold market low in 1999, the economy and the Fed were in the midst of a transition.

From personal experience, just before the bottom in gold prices in 1999, coming up with interesting ideas for the daily comments on gold the market became very difficult, as the price range on many days was less than $3 an ounce. But when we realized that almost all of the normal players in gold were already short one way or another, we recognized how extreme the situation had become. We suggested in our daily “Hightower Report” comments that traders were likely to see an extreme, compacted short covering rally. While the short covering rally that did unfold would hardly be headline-grabbing today, in the sleepy gold market of 1999 it was quite dramatic.

Inflation – The Final Act for Gold?

If we take the lessons from the past, we might use the opposite extremes of those factors that collected around the 1999 bottom in gold as a signal to when gold might fully factor in the brunt of the bull fundamentals that have been driving gold prices upward.

* The first place to start for a physical commodity like gold is production. The sharply rising gold prices from mid 2000 took awhile to encourage mine expansion. Production did not really start to show signs of a turnaround until early 2010, and even into the end of 2010 not all producers were seeing their production rise consistently. However, over the past two years the gold market has seen a noted pickup in scrap mine and recycled jewelry supply, and that in conjunction with more recent, conventional efforts to increase mine output suggests that gold prices are now starting to work their magic on supply.

* The speculative positioning in the futures market posted a new record spec long position in 2009 and managed to post new records a number of times in throughout 2010. In addition to consistent spec positioning in futures, money pouring into gold derivative products also exploded, and that would seem to leave the speculators significantly longer than at any time in modern history.
* At the end of the 3rd quarter 2010 we started to see the first predictions that some Central Banks were reversing course, from being net sellers to being net buyers of gold. However, ideas that Chinese central bank gold buying might have a long way to go before they are satiated could mean that central bank buying has yet to reach a peak.

* By mid-2010, several of the world’s largest gold producers were well into programs to buy back their “hedges.” While the de-hedging process was effectively started as early as 2004-2005, some producers moved so quickly and aggressively that they were required to float large public offerings just to get the cash to buy back losing positions. Apparently a large portion of the investing public wanted exposure to gold through gold mining companies, and mining company officials responded by working off hedges quickly.

For now, the investment front remains the opposite of 1999, as a long list of investment instruments like real estate, corporate bonds, sovereign debt and others are still highly suspect and gold is still being viewed with favor. In fact, going into the 4th quarter, gold was still considered as being one of the few viable flight-to-quality instruments in an environment where economic and political uncertainty continued to reign. However, sentiment might have begun to reach extreme levels in the face of suggestions from the World Bank President that a return to some form of gold standard would help avoid currency wars, as that would seem to suggest that bullish sentiment for gold is indeed at a lofty level.

Clearly, many markets were expecting US Fed policy to remain loose, as the FOMC had made it clear in early November that quantitative easing would be aggressively utilized until the US economy responded. However, the markets have already seen rate hikes from Canada, Australia and China. And there are pockets of the Euro zone also getting to a point were a change of policy might be necessary. Therefore, while US monetary policy is mostly expected to remain supportive to gold, it is unclear how long that condition will remain in place.

A number of the bearish factors from 1999 have already been reversed and are progressing quickly toward an inflection point, but the gold market could be lifted for months off the “inflation or bust” scenario that seems to have been employed by the US Fed. Surprisingly, the gold market has seen almost a decade of gains without classic inflationary psychology serving as its driving force. However, as 2011 approaches we suspect that the sub-prime/sovereign debt crisis will either rear its ugly face again (which could result in a blow off flight to quality rally in gold), or that crisis will truly begin to recede and the gold market will then see an impressive extension of the 2008-2010 rally off classic inflationary expectations.

The gold market might have as much as 90% of its bull wave completed already, but given the historic easing posture of the US Fed, the potential for sustained Chinese central bank buying and the high degree of uncertainty still facing the world economy, it would seem like inflation will be allowed to gain some sort of foothold before the US Fed can effectively pull back on the reigns.

**Growing Volatility a Precursor to a Top?**

Even though funds and small specs have already reached record or near record net long positions in gold, we think we will still see a ratcheting upward of those positions in the event that true inflationary expectations begin to dominate the daily trade. So far, gold appears to have been driven higher by a combination of flight to quality, currency influences and a lack of alternative investments and that inflation wasn’t really part of the equation until early September.

As we approached mid-November, the technical outlook suggested that the gold market had finished off a corrective decline off of the October 14th highs at $1388.10 by forging
yet another strong sprint into new high ground. Gold prices have already seen a parabolic move off of the July 2010 lows at $1159.30, climbing more than $244 in less than four months.

However, the decline off of the October highs was on lighter volume, and the subsequent bounce in November was initially forged on even lighter volume than the late July rally, and the November rally was also accompanied by a slight decline in open interest!

Nonetheless, the gold market seems to be set up for a rather significant high ahead. There appears to be a cluster of upside price targets located in the $1450 to $1570 area, with the top timing anticipated to be as late as June, 2011. However, we cannot rule out the potential for a more dynamic price advance toward $1,600 if unexpected historical developments like a real currency war were to surface.

A look at the uptrend channel off of the November 2008 lows at $699 projects a further upside push toward the $1570 level. The first advance took 13-months to travel $181, and using the February 2010 lows at $1052 as a second push measurement (legs of equal proportion) points to a further upside charge to $1570 by the 1st Quarter of 2011.

Using the May 2006 peak to the March 2008 peak swing, the gold market carved out a monthly channel range of $350. As a point of reference, the 2010 low for gold was $1045.20, and the high so far is $1,409.40, a move of $354. Based on that action we would come up with 2011 projected upper price range of $1,490 to $1,600.

From cycle analysis using the daily charts, a 109 day high to high cycle would produce a top timing of March 17th, 2011. Looking backward, the 109 day cycle high timing coincides with the October 15th, 2010 high, the May 12th, 2010 high and the December 3rd, 2009 high.

For trading strategies and updates, please visit our blog: thehightowerreport.com.